Statement of
Gordon G. Chang
Before the
House Committee on Foreign Affairs

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Chairwoman Ros-Lehtinen and distinguished members of the Committee:

It is a privilege for me to appear before you today, and I thank you for this opportunity.

My name is Gordon Guthrie Chang. I am a writer and live in Bedminster, New Jersey. I worked as a lawyer in Hong Kong from 1981-1991 and Shanghai from 1996-2001. Between these two periods, I frequently traveled to Hong Kong and China from California. I continue to travel there now.

I am the author of *The Coming Collapse of China* (Random House, 2001) and *Nuclear Showdown: North Korea Takes On the World* (Random House, 2006). I am a Forbes.com columnist and write regularly about China.

Most Americans fundamentally misunderstand the economic relationship between the United States and China. I want to comment on three of these misunderstandings: China's dependency on the American market, America's dependency on China buying American debt, and the effect of Beijing's currency manipulation.

China's Dependency on America

First, most of us believe that the Chinese economy has become less dependent on ours. The generally accepted narrative is that, as the American economy tumbled during the Great Recession, China's exporters looked to other markets.

In 2008 and 2009, every China analyst—including me—believed Chinese exporters were successful in diversifying away from the U.S. This storyline seemed true because it made so much sense. Trade numbers, however, tell a different story.

In 2008, 90.1% of China's overall trade surplus related to sales to the United States. So what happened in 2009, the first full year of the downturn? That percentage increased to 115.7%.

And what happened last year? China's trade surplus last year was $183.1 billion, according to the official Xinhua News Agency.

Through the first 11 months of last year, U.S. Commerce Department figures show China's trade surplus against the United States was $252.4 billion. That's up from $208.7 billion for the same period in 2009, a 20.9% increase.

The Commerce Department has not released the December trade number yet. China's surplus for that month should end up somewhere around $22 billion. Yet let's assume, purely for the sake of argument, that China's December surplus was zero. If December's surplus was zero—not very likely—137.8% of China's overall trade surplus last year related to sales to the United States.

China's increasing trade dependence on the United States gives Washington enormous leverage over Beijing, especially because a large portion of the Chinese surplus is attributable to violations of its World Trade Organization obligations. China has an increasingly turbulent economy, heavily dependent on exports. And its exporters, despite all the talk about their "diversification," increasingly need the American market.

Beijing's Holding of U.S. Debt

Second, just about everybody says that Beijing's holding of American debt gives China a hold over the United States.

They are right—but only because we think it does. China's holding of Treasury debt—$906.8 billion as of October 2010—would not be a weapon if we properly understood how global markets work.

Because of China's increasing dependence on exports to America, Beijing has to buy American debt as a practical matter. It receives dollars from its export sales and has to invest those dollars somewhere. The Chinese could convert their dollars into other currencies, but no other currency has a deep-enough market. Furthermore, the euro, an alternative to the dollar, may not exist, say, two years from now, complicating Beijing's diversification plans. China is stuck with the dollar for as long as it is stuck with the American market.

Chinese officials periodically threaten to diversify their holdings and to stop buying U.S. Treasury obligations. It seems there has been some diversification of China's foreign exchange reserves but not enough to make a difference to the Treasury Department's fund-raising plans. Even when Beijing sells Treasuries from accounts analysts watch, it appears the Chinese buy through nominee accounts—in other words, they try to hide their purchases.

Chinese officials have publicly threatened to dump our debt in global markets since August 2007. They call this tactic, appropriately enough, the "nuclear option."

China's officials have not nuked us because they know their attack plan won't work. Let's suppose the worst case scenario of Beijing trying to dump all its dollars at one time. What would happen? The Chinese would have to buy something, as a practical matter, pounds, euros, and yen. The values of those currencies would then shoot up through the ceiling. London, Brussels, and Tokyo, to bring down the values of their currencies, would then have to go into global markets to buy . . . dollars. In short, there would be a great circular flow of cash in the world's currency markets.

There would be turmoil in those markets, but it would not last long, perhaps just a few weeks. And we would end up in just the same place that we are now, except that our friends would be holding our debt instead of our adversary. Global markets are deep and flexible and can handle just about anything.

Hillary Clinton, in 2005, famously said we can't argue with our Chinese bankers. I think we can.

I hasten to add that I do not want China to hold a single cent of our debt, but, because it does, we need to understand the limits of the power that such holding confers on Beijing.

China's Manipulation of the Renminbi

Third, you hear many commentators say that changing China's currency practices will not solve America's trade deficit. Of course that's true—but only because Beijing's currency manipulation is not the *sole* reason for the plight of American manufacturers and workers. Yet Chinese manipulation is an *important* factor.

China has, during various periods, pegged its currency and allowed a "dirty float." Throughout all these times, the yuan, as the renminbi is informally know, has been kept at an artificially low level. Today, Beijing continues to intervene in its market so that the currency hits a target in the middle of a moving band, and it does so to give an advantage to its exporters. Due to this active intervention, no one knows the true value of the renminbi, but the discount to market value is thought to be somewhere in the vicinity of 30 percent.

A discount of that magnitude is, of course, significant. I practiced law for more than two decades, much of it in Asia. I represented parties involved in trade between China and the United States and often saw them haggling for days over pennies when negotiating unit prices. A swing either way of a few cents had a disproportionate effect on the success of the business of my clients. So it is counterintuitive to think that currency manipulation, which can change the price of a product by thirty or forty percent, would have no affect on our country's trade deficit.

But don't take my word for it. Listen to China's top economic official. Premier Wen Jiabao, last September, raised the possibility of "countless Chinese enterprises going bankrupt and countless Chinese workers becoming unemployed" if the renminbi were to appreciate substantially. If China's enterprises and workers would suffer if he did not manipulate the renminbi, then how can anyone maintain that our manufacturers and our workers are not disadvantaged by his currency policy?

Nonetheless, economists and analysts tell us we shouldn't complain about China's predatory currency policies. For instance, they maintained that the China currency bill the House passed late last September—H.R. 2378, the Currency Reform for Fair Trade Act—was the result of misguided protectionism.

It is a mystery to me why trying to do something about protectionism is itself considered protectionist. In my view, the United States should do all it can to bring Chinese currency practices in line with those of China's trading partners. The real risk for us—America and the rest of the global community—is that Beijing will take too long to do so. Asian nations are already depressing the value of their currencies to make their exports more competitive with China's. In the 1930s, tariff walls deepened the Great Depression and prolonged it. This time, more subtle—but probably as destructive—measures look like they will produce the same effect.

China won't change its destructive currency policies if we merely appeal to its self-interest—the approach of the current administration and the preceding one. China will change its currency policies only when the United States acts to defend its manufacturers and workers. If the administration won't act, Congress should.

Thank you.